

Introduction to Economics

Lecture 8

MGM112

Monetary, and Fiscal Policy

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Chapter
08**Monetary, and Fiscal Policy**

After studying this chapter, you will be able to

- Describe the structure of the Federal Reserve System (the Fed), and the tools used by the Fed to conduct monetary policy
- Explain what an open market operation is, how it works, and how it changes the quantity of money
- Explain how the Fed influences interest rates
- Explain how the Fed's actions influence spending plans, real GDP, and the price level

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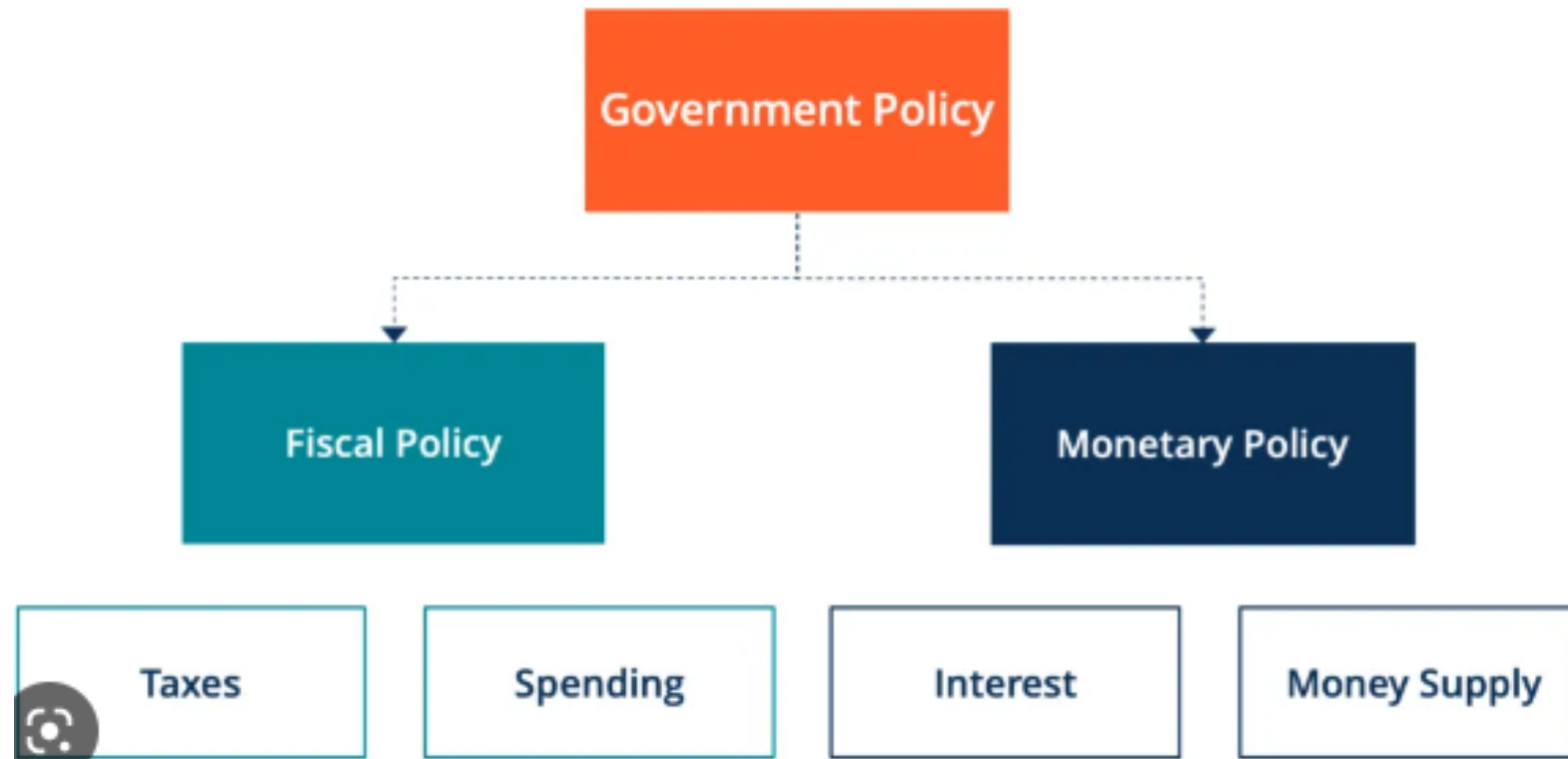
Learning objectives

After studying this chapter, you will be able to

- Understand what fiscal policy is and how it impacts the economy
- Apply fiscal policy to economic booms and busts to solve those issues effectively

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Monetary, and Fiscal Policy



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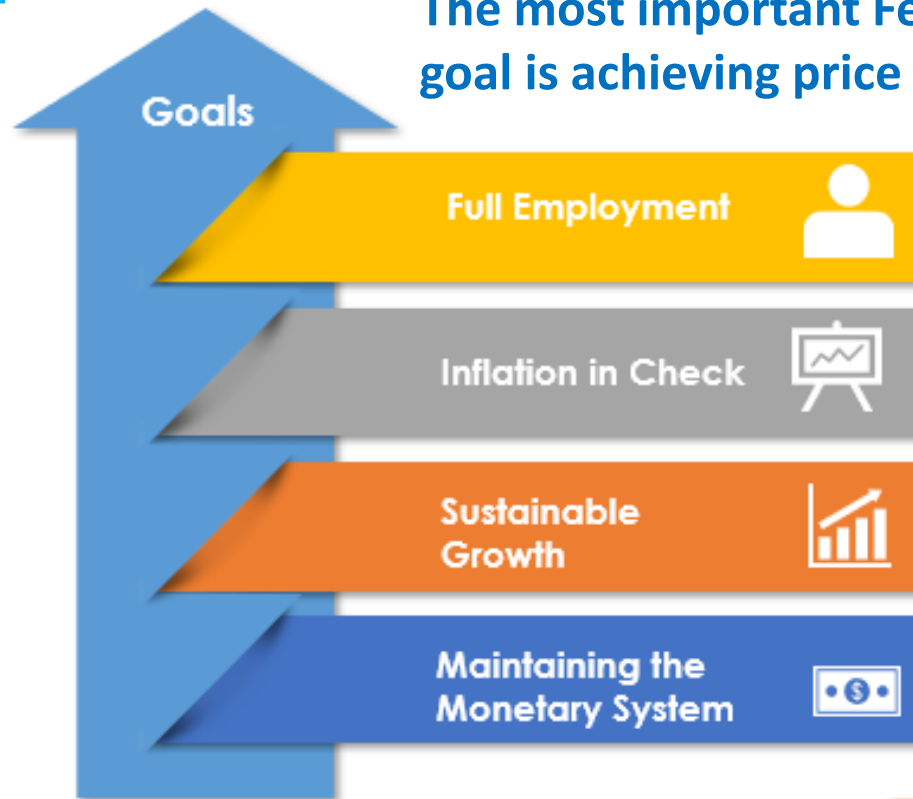
Monetary, and Fiscal Policy

1) Monetary Policy

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Monetary Policy

The most important Federal Reserve monetary policy goal is achieving price level stability



Monetary Policy

Alteration of the money in circulation to influence the state of the economy



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Monetary Policy

Who is Responsible for the Monetary Policy

A **CENTRAL BANK/ Federal Bank** is the public authority that regulates a nation's depository institutions and controls the quantity of money.

It is an independent authority in most of countries of the world



EUROPEAN CENTRAL BANK



Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem



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Monetary Policy

Monetary policy affect money in circulation, and interest rate through 3 tools:

- 1) Discount Rate
- 2) Deposit Reserve
- 3) Open Market Operation

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Monetary Policy

Tools monetary policy1) Discount Rate (-Ve).

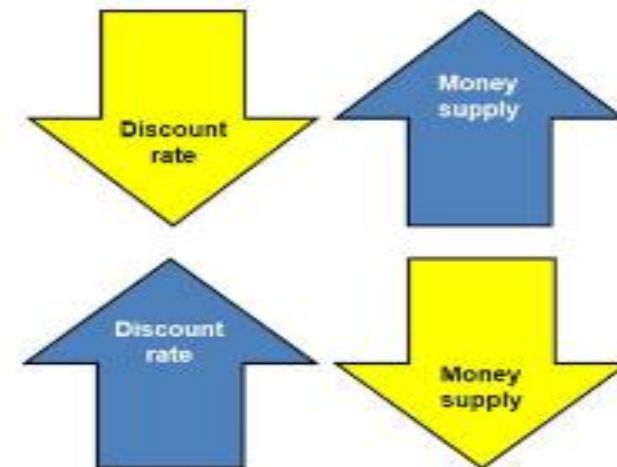
- **The discount rate** is the interest rate at which the Fed stands ready to lend reserves to depository institutions

Reducing the Discount Rate

A decrease in the discount rate makes banks more willing to borrow from the Fed. This causes banks to increase lending, causing the money supply to expand.

Increasing the Discount Rate

An increase in the discount rate makes banks less willing to borrow from the Fed. This causes banks to reduce lending in order to build reserves, causing the money supply to contract.



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Monetary Policy

Tools monetary policy2) Deposit Reserve (-Ve).

- **Required reserve ratio** are the total amount of reserves that banks are required to keep.
- **The Central banks** set the required reserve ratios, which are the minimum percentages of deposits that depository institutions must hold as reserves
- The higher RRR, the lower available loans for people, causing decrease in money supply, and increase in interest rate.

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Monetary Policy

Tools monetary policy

3) Open Market Operation

- Open market operations are used mainly **to regulate the money supply** in an economy **by selling and buying government securities/ bonds** by the central bank of a nation

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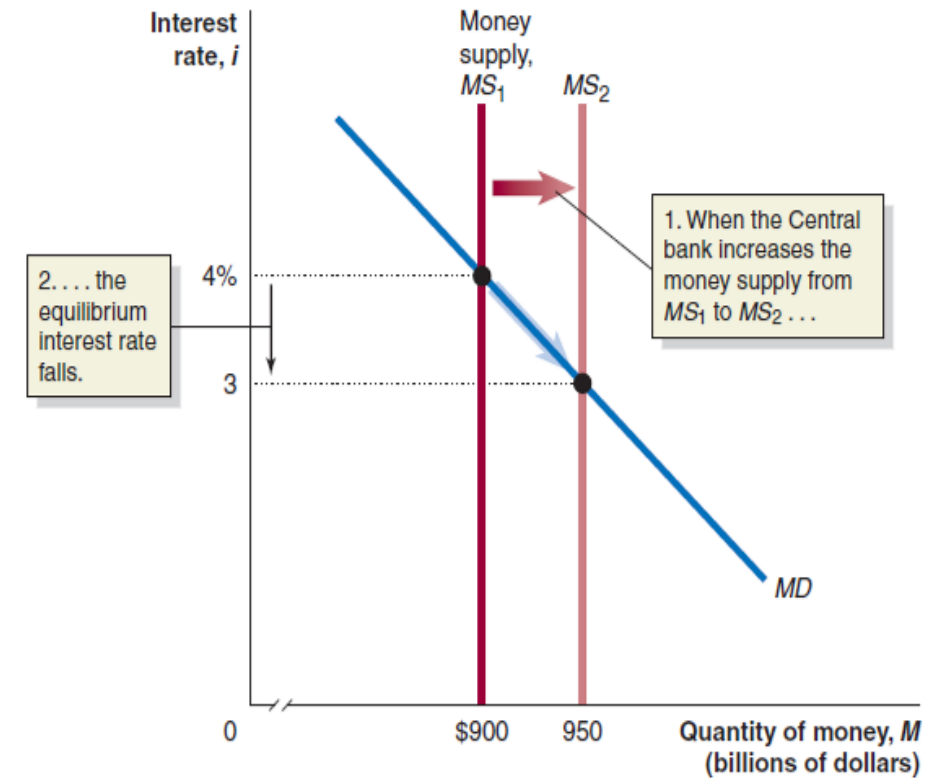
Monetary Policy

Tools monetary policy

3) Open Market Operation

To control Recession

- increase the money supply
- the equilibrium interest rate decreases
- people prefer to hold money (sell bonds)
- the central bank buys back bonds from commercial banks.



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Monetary Policy

Tools monetary policy3) Open Market Operation

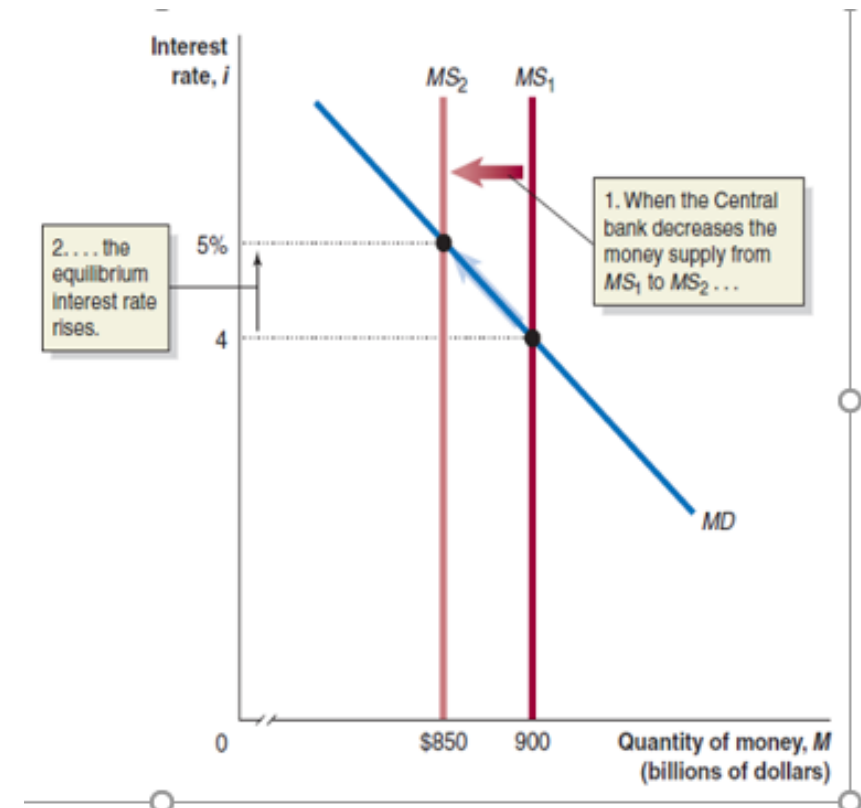
To control Expansion/ Inflation

→ decrease the money supply

→ the equilibrium interest rate increases

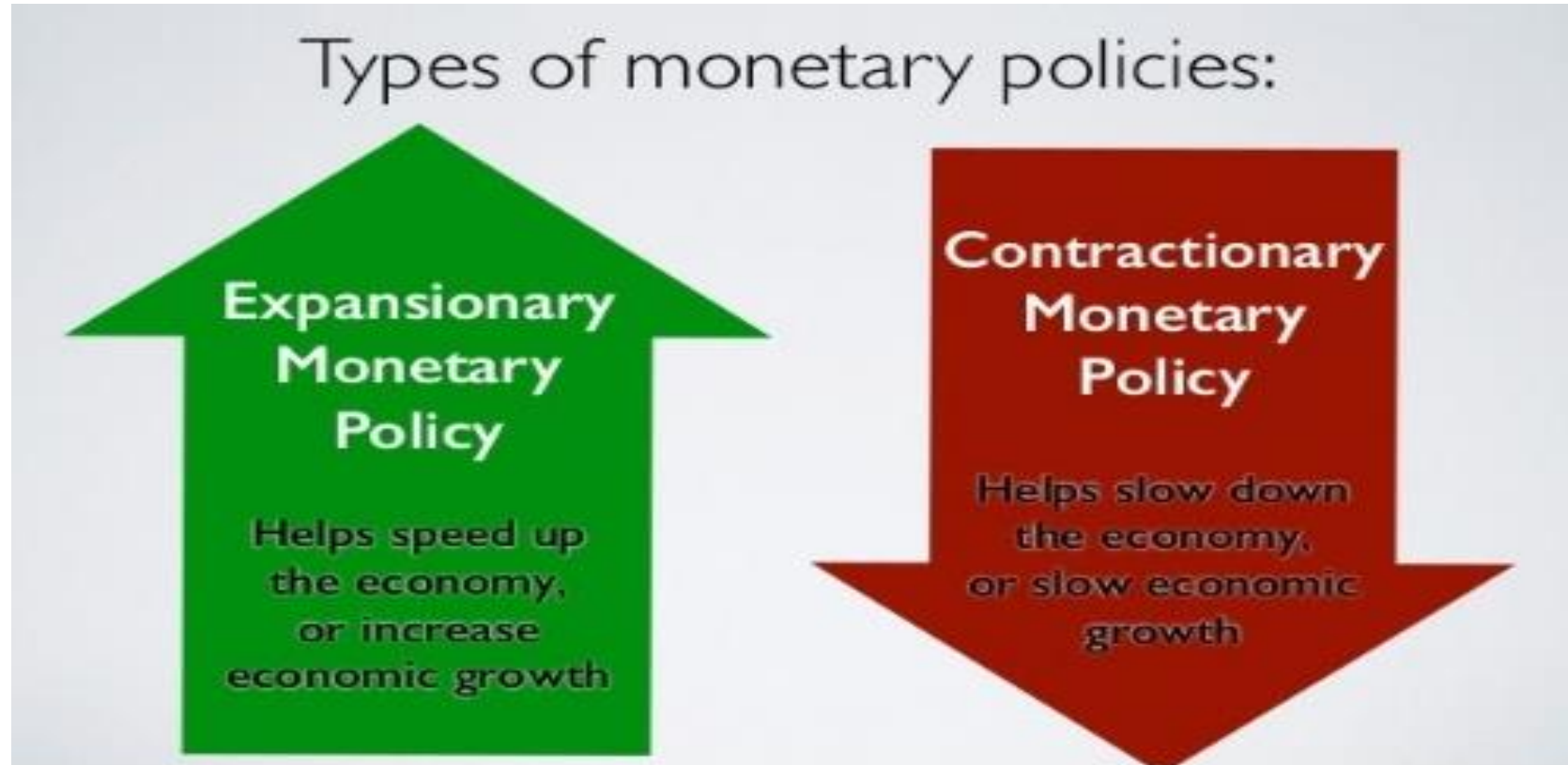
→ people prefer to hold bonds (buy bonds)

→ the central bank **sells** bonds to commercial banks



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Monetary Policy



Monetary Policy

1) Expansionary MP

At the time of **recession, and Unemployment**

1. CB buys bonds through open market operations
2. CB reduces discount rate
3. CB reduces RRR

↓
MS↑

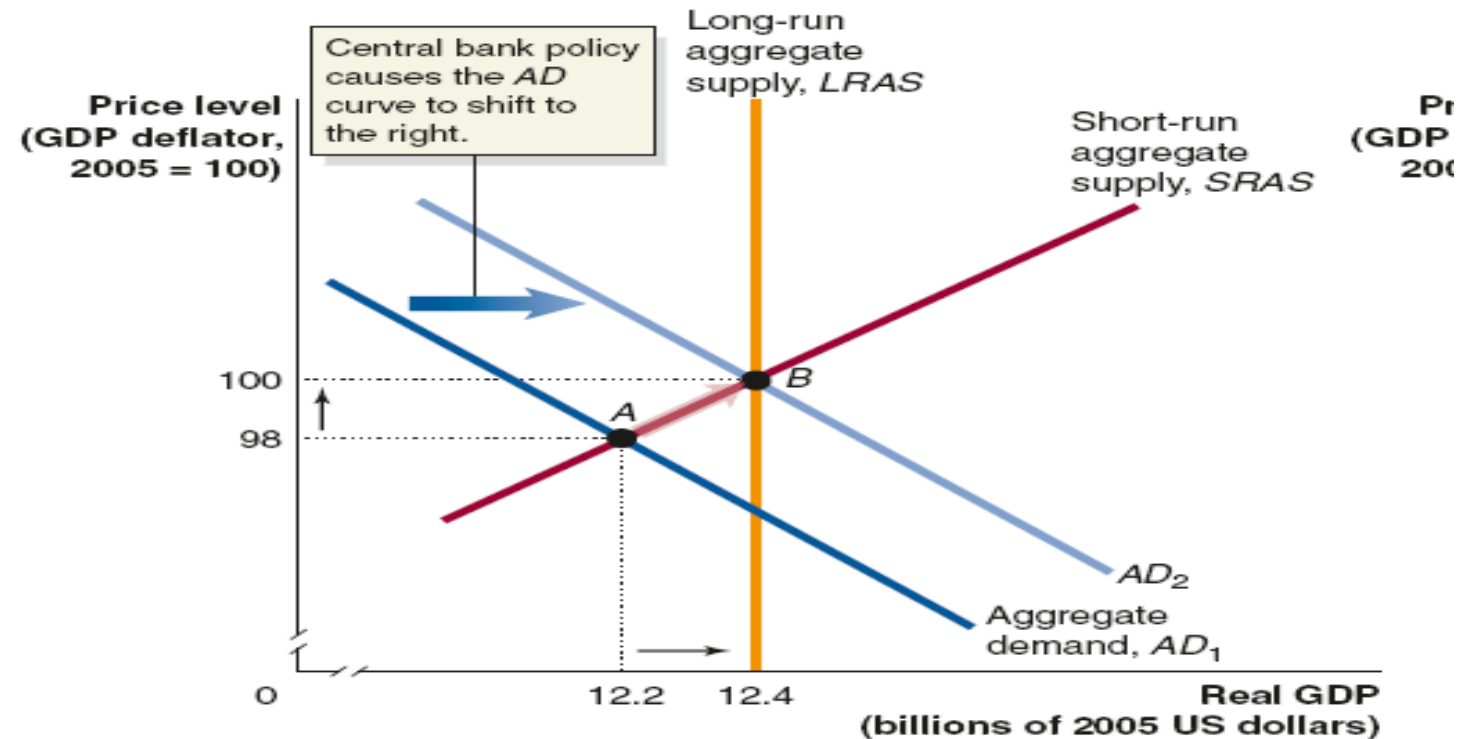
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I↑

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AD↑

↓
Output (GDP), and Prices (inflation)↑

1) Expansionary MP



(a) Expansionary monetary policy

Monetary Policy

2) Contractionary MP

At the time of **expansion, and inflation**

1. CB sells bonds through open market operations
2. CB increases discount rate
3. CB increases RRR

↓
MS↓

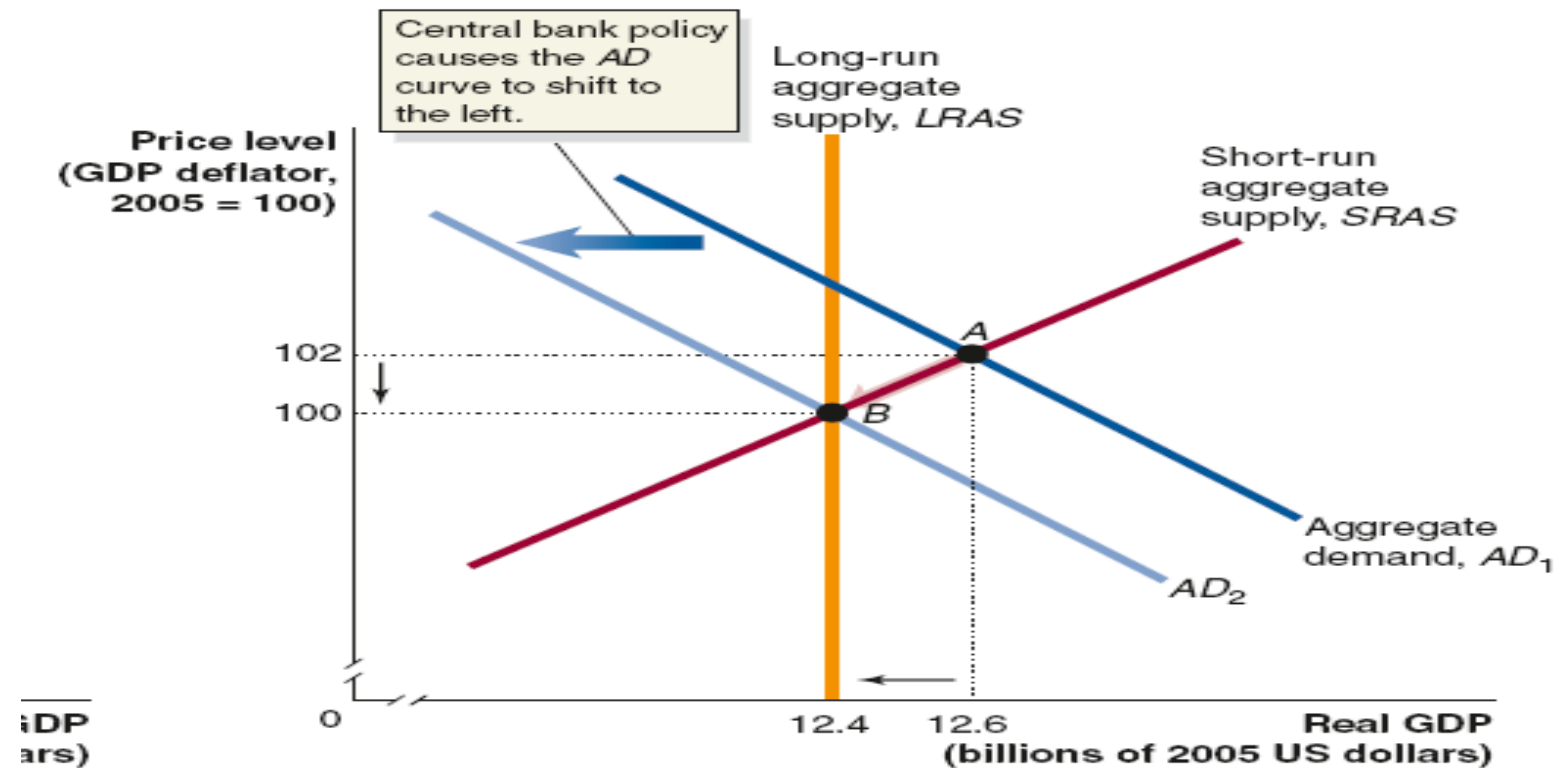
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AD↓

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Output (GDP), and Prices (inflation)↓

2) Contractionary MP



(b) Contractionary monetary policy

Think

What is meant by monetary policy?

- A. The process by which the Parliament controls the money supply
- B. **The process by which the central bank or monetary authority of a country controls the supply of money**
- C. The process by which International Market controls the money supply
- D. None of the above



Think

If interest rate decreases in an economy, it will

- A. Decrease the investment expenditure in the economy
- B. Increase the loan repayment by the government
- C. **Increase the consumption expenditure in the economy**
- D. Increase the total savings in the economy



Think

If the economy experiences an expansionary gap and the Fed sells US government securities in the open market, then ____.

- A. money supply increases, investment increases, aggregate demand increases
- B. money supply increases, the interest rate increases, and the aggregate demand increases
- C. money supply decreases, the interest rate decreases, and the aggregate demand falls
- D. money supply decreases, the investment decreases, and the aggregate demand decreases



Think

Which of the following is not a monetary policy instrument?

- A. Reserve requirement ratio.
- B. Interest on reserve. (Discount rate)
- C. **Capital gains tax rate.**
- D. Open market operations.



Think

Which of the following is not one of the Fed's monetary policy tools?

- A. Buying bonds on the open market
- B. Selling bonds on the open market
- C. Raising or lowering taxes**
- D. Raising or lowering the reserve requirement ratio

An open market purchase by the Fed

- A. increases bank reserves, loans, and deposits, and thus increases the money supply.
- B. decreases bank reserves, loans, and deposits, and thus decreases the money supply.
- C. increases bank reserves, loans, and deposits, and thus decreases the money supply.
- D. decreases bank reserves, loans, and deposits, and thus increases the money supply.**



Think

Suppose the Fed wanted to engage in an expansionary monetary policy. Which of the following should it do?

- A. Sell bonds on the open market.
- B. Increase the reserve requirement ratio.
- C. Increase the discount rate.
- D. **Buy bonds on the open market.**

Expansionary Monetary policy is a monetary policy designed to decrease activity in the economy.

- A. True
- B. **False**

- False, Contractionary MP



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Monetary, and Fiscal Policy

2) Fiscal Policy

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Fiscal Policy

- Fiscal Policy is determined by **government/ congress/ president (Fiscal Authorities)** using **Taxes and the government expenditure** to influence economic conditions
- **Goals:**
 - Boosting employment level to achieve Full Employment
 - Inflation in Check
 - Maintain Sustainable Growth

Fiscal Policy

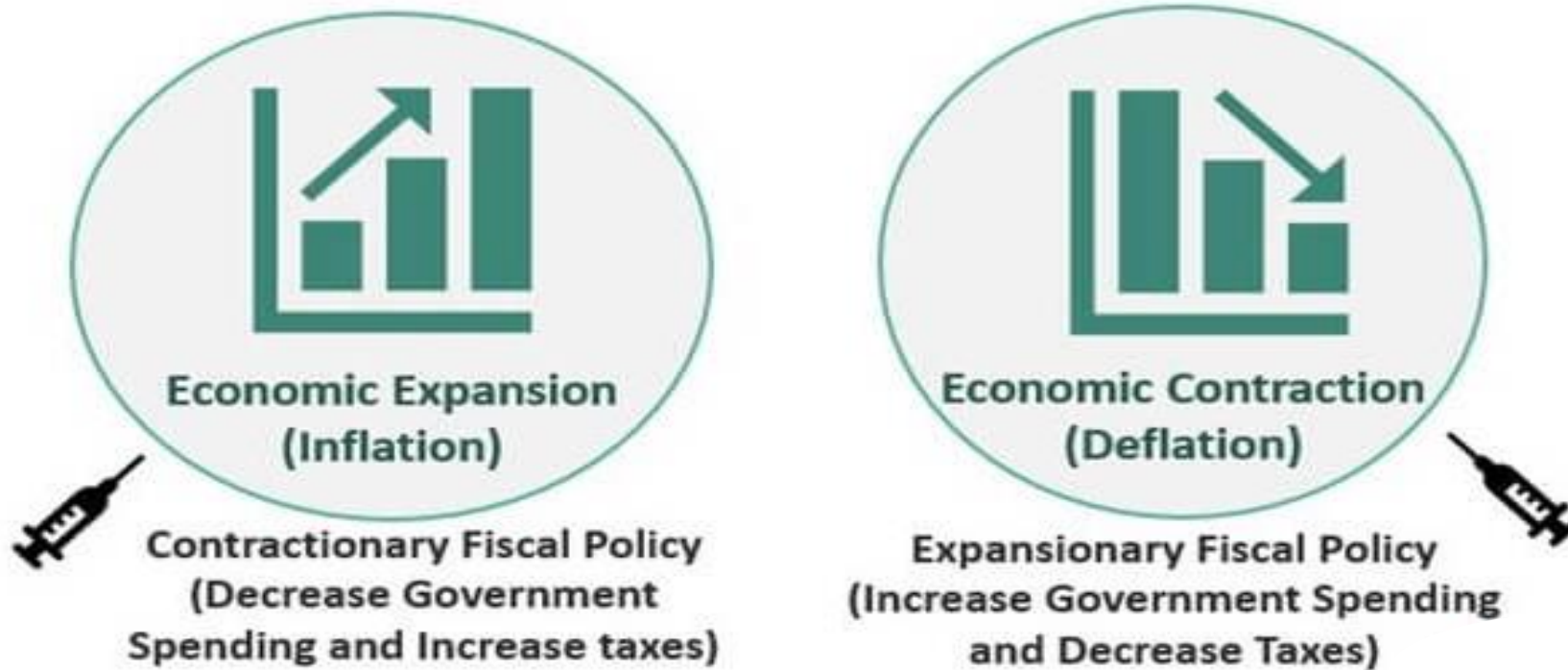
$$\text{Government Budget} \equiv G - T$$

- If Expenditure more than Revenue ($G > T$), **Budget Deficit**,
- If Expenditure less than Revenue $G < T$, there would be a **Budget surplus**
- If Expenditure equals Revenue $G = T$, there would be a **Budget balance**

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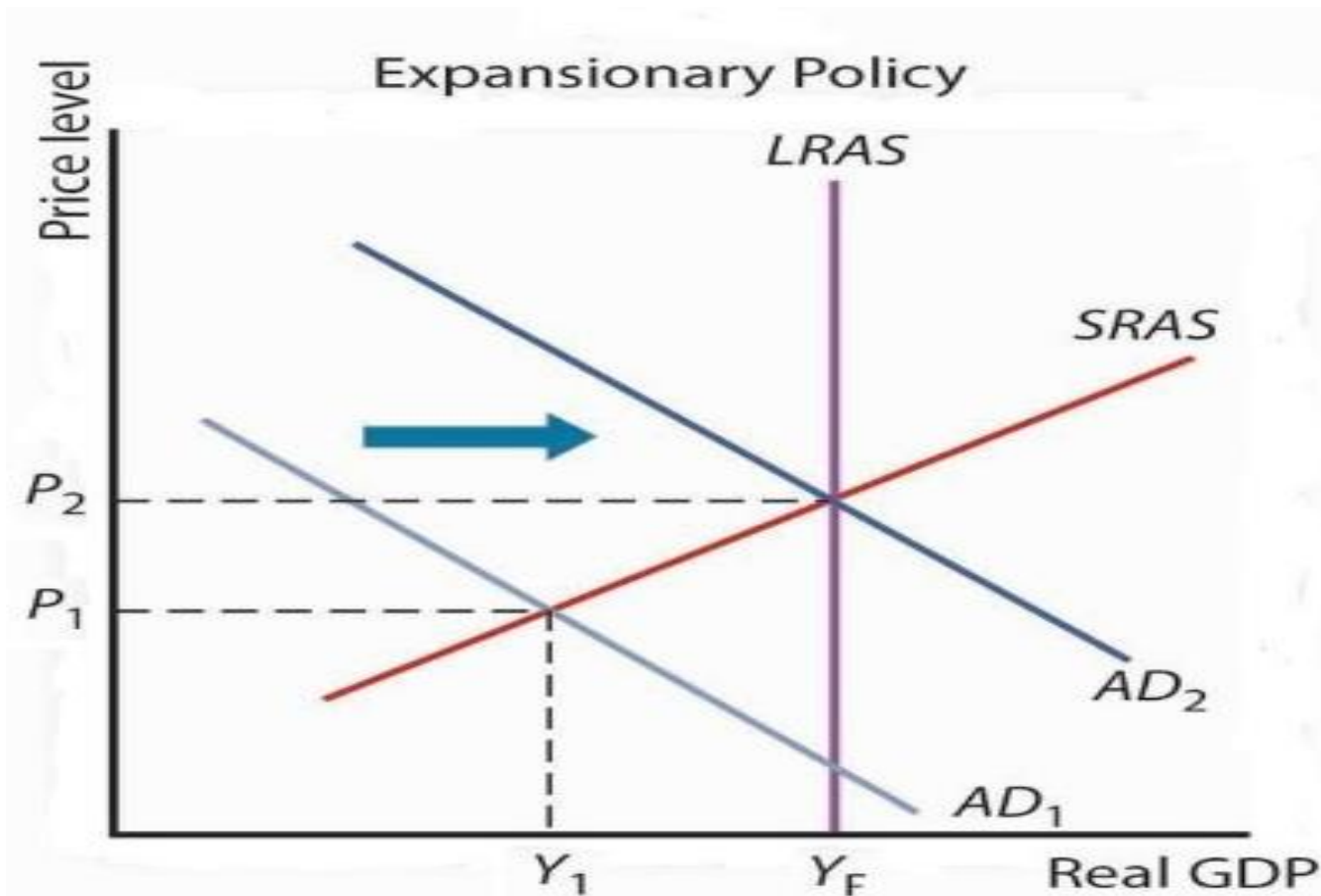
Fiscal Policy

Types of Fiscal policy



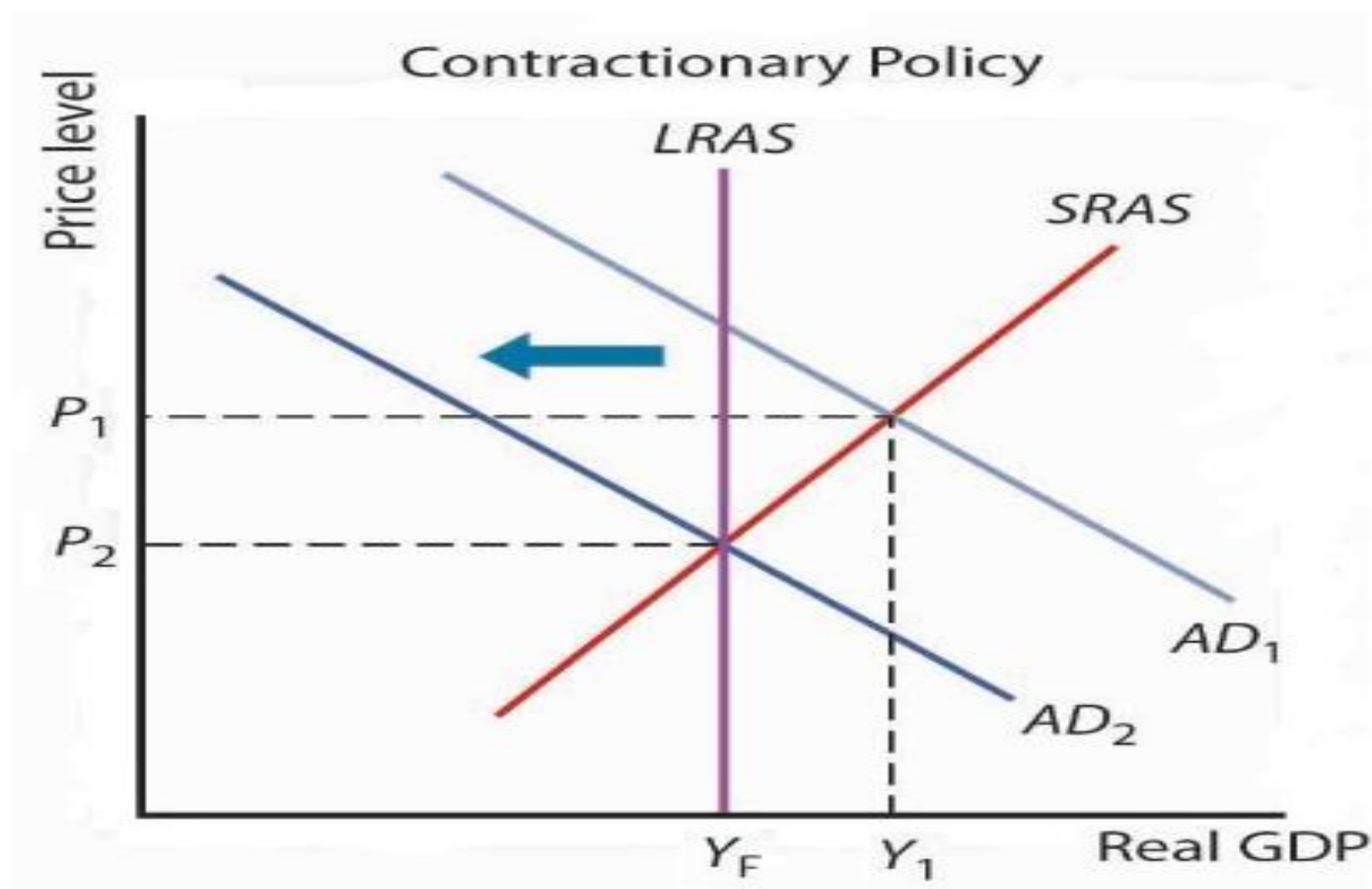
	Expansionary fiscal policy
When	Stimulate the economy during <u>the recession (during Budget surplus)</u>
Action	$T \downarrow$ or $G \uparrow$
results	$T \downarrow$: consumer spending $\uparrow$ $G \uparrow$: Business investment $\uparrow$ AD curve <u>increases and shift to the right</u>
effect	Real GDP $\uparrow$ Price level $\uparrow$ Employment $\uparrow$

1) Expansionary FP



	Contractionary fiscal policy
When	Stimulate the economy during <u>inflation</u> (during Budget Deficit)
Action	$T \uparrow$ or $G \downarrow$
results	$T \uparrow$: consumer spending $\downarrow$ $G \downarrow$: Business investment $\downarrow$ AD curve <u>decreases and shift to the left</u>
effect	Real GDP $\downarrow$ Price level $\downarrow$ Employment $\downarrow$

2) Contractionary FP



Think

----- is known as the policies that fiscal authorities adopt

- A. Public policy
- B. Fiscal policy**
- C. Government policies
- D. None of the above



Think

Fiscal policy is defined as the policy under which

- A. The government uses instruments of taxation
- B. The government uses instruments of Government spending
- C. Government has a predetermined purpose of economic policy
- D. **All of the above**



Think

Which of the following are the tools of fiscal policy?

- A. Taxation
- B. Government research
- C. Government borrowing
- D. None of the above



Think

Which of the following objectives are achieved by fiscal policy?

- A. Economic stability
- B. Achieving high level of employment
- C. Accelerating economic growth
- D. **All of the above**



Think

Budget is an instrument of

- A. Monetary policy of the government
- B. Commercial policy of the government
- C. **Fiscal policy of the government**
- D. Money-saving policy of the government

Fiscal policy creates a surplus, when the total-----

- A. Expenditure and total receipts same
- B. **Receipts more than Expenditure**
- C. Expenditure over Receipts
- D. Receipts and total Expenditure very low



Think

When the governments total revenue is less than the planned expenditure, it is called----

- A. Revenue deficit
- B. Budget shortfall
- C. **Fiscal deficit**
- D. Deficit financing



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Summary outlines

- **Monetary policy (definition, tools, expansionary, and monetary policy)**
- **Fiscal policy (definition, tools, expansionary, and fiscal policy)**



Thank You